

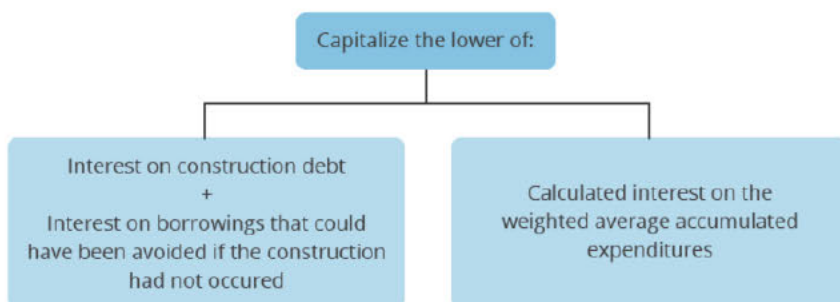
7.03 Capitalization of Interest

Overview

Interest cost incurred during the construction period needs to be capitalized. (ASC 835) The amount capitalized is considered the **avoidable interest** (could have avoided had you not built the building). This amount is added to the cost of building the asset. Interest incurred on construction loans should be included, but only to the extent the funds have been spent on construction.

- Capitalize interest cost if an asset is either:
 - Constructed for company's **own use** (ie, built by self or an outsider), or
 - Manufactured for resale resulting from a **special order** (eg, a ship).
- Do **not** capitalize interest if costs are incurred:
 - **After completion** of construction, or
 - For **inventory** manufactured in the ordinary course of business.
- The capitalized **amount** of interest:
 - Is equal to:
 - Weighted Average Accumulated Expenditures (WAAE) \times Interest Rate
 - Includes interest on other debt that could have been avoided by repayment of debt
 - Is never to exceed actual interest cost incurred

Capitalized interest on self-constructed assets



Calculations

To calculate the WAAE, expenditures must be weighted for the number of months they are outstanding in the capitalization period and then added together.

$$\text{Expenditure} \times \left(\frac{\text{months outstanding}}{\text{capitalization period}} \right)$$

- The **months outstanding** will be the number of months between the date of the expenditure and the end of the capitalization period.
- The **capitalization period** is often 12 months, but it could be less if, for example, construction begins or ends during the year.

For example, if there are three expenditures during the year, occurring on the first of the month in each of January, April, and December for \$100,000, \$300,000, and \$360,000, respectively, the WAAE would be calculated as follows:

1/1/Year 1	\$100,000	×	12/12 =	\$100,000
4/1/Year 1	\$300,000	×	9/12 =	\$225,000
12/1/Year 1	\$360,000	×	1/12 =	\$30,000
			WAAE =	\$355,000

Note that if **expenditures are incurred evenly throughout the year**, the calculation is mathematically equivalent to the entire year's expenditures being made halfway through the period (ie, annual expenditures × ½).

When calculating the WAAE for a **subsequent period**, the ending balance of construction in progress (CIP) from the prior year must be included in the WAAE calculation for the subsequent year. Ending CIP for the prior year (or beginning balance for the subsequent period) will equal accumulated expenditures plus capitalized interest.

Assume that a client takes out a 12% loan of \$1,000,000 on 1/1/X1 to finance construction of a building for the company's own use. Construction begins immediately, and \$600,000 is spent at an even pace during 20X1. The remaining \$400,000 is spent at an even pace during 20X2, with construction completed on 12/31/X2. The capitalized interest is computed as follows:

20X1	
WAAE (Annual expenditures / 2)	\$600,000 / 2 = \$300,000
Capitalized interest (WAAE × 12%)	\$300,000 × .12 = \$36,000
20X2	
Beginning CIP	\$600,000 + \$36,000 = \$636,000*
WAAE (Annual expenditures / 2)	\$400,000 / 2 = \$200,000
Total WAAE for 20X2	\$636,000 + \$200,000 = \$836,000
Capitalized interest for 20X2	\$836,000 × 12% = \$100,320

The capitalized interest of \$36,000 for 20X1 and \$100,320 for 20X2 represent a portion of the total interest paid by the company each year.

Let's assume that the \$1,000,000, 12% loan requires annual interest payments at the end of each year. The entries to **record** the **interest payments** would be:

12/31/X1		
Building CIP	36,000	
Interest expense (plug)	84,000	
Cash		120,000

12/31/X2		
Building CIP	100,320	
Interest expense (plug)	19,680	
Cash		120,000

Once construction is finished, the building is no longer a work-in-process, but a completed asset, and the entire balance of Building CIP is transferred to Building. Any interest incurred after 12/31/X2 is expensed immediately, in accordance with the matching principle, as the building is now being used and providing benefits to the company. The capitalized interest will now be a part of the depreciation expense on the building over its useful life.

**Outstanding for an entire year. If the building had been completed before year-end, this amount would have to be weighted for the number of months outstanding.*

Since **capitalized interest** must be calculated to determine **interest expense**, be careful not to stop at capitalized interest when they are asking for interest expense!